STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company Application for Review of Alternative Regulation Plan	))))	Docket No. 98-0252
Illinois Bell Telephone Company Petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates	)))))	Docket No. 98-0335
Citizens Utility Board, People of the State of Illinois v. Illinois Bell Telephone Company	)))))	Docket No. 00-0764 (Consol.)

INITIAL BRIEF OF AMERITECH ILLINOIS

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Dated: March 22, 2001

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Illinois Bell Telephone Company ("Ameritech Illinois" or "the Company"), by its attorneys, hereby files its Initial Brief in the captioned consolidated proceeding.

I. SUMMARY OF POSITION

A. INTRODUCTION

When this Commission adopted Ameritech Illinois' Alternative Regulation Plan in 1994, its Order constituted a watershed in Illinois regulatory policy. The Commission completely overhauled rate of return regulation, which had not changed in over 70 years, and replaced it with a regulatory model which would meet the demands of a changing and increasingly competitive marketplace. It is beyond dispute that the industry has continued to evolve over the last six years. Although the Commission had certificated numerous providers of interMSA and intraMSA services by 1994, local exchange competition was still in its infancy. Since then, voice and data CLECs have entered the market, creating brisk competition for business customers. Although residence competition has developed more slowly, the combined effect of changes required by TA96, the advent of long distance relief for incumbent local exchange companies and consumer demands for "one stop shopping" will likely spur competitive activity in the coming months and years. In addition, the dramatic growth in wireless competition, data traffic and Internet use by both businesses and consumers are likely to put pressure on all traditional carriers, including Ameritech Illinois, to reassess their networks and traditional service models.

The Commission correctly recognized in 1994 that rate of return regulation is simply not sustainable in this kind of market environment. The regulatory process is too slow; the traditional tools used by regulators to ensure capital recovery are inadequate, as technology changes rapidly and the marketplace sets price levels; after-the-fact prudency reviews of management decisions are patently unworkable; and competition and changing technology combine to make business and investment decisions in the telecommunications industry riskier than ever. Rate of return regulation inherently subjects customers of noncompetitive services to the financial consequences of these risks.

In response, the Commission put in place a price regulation plan which addressed directly its core regulatory responsibility: i.e., to assure the availability, affordability and quality of services for which customers do not yet have a competitive alternative. The price index component of the Plan ensures that customers are protected from unreasonable price increases and the financial impact of competition on Ameritech Illinois. By eliminating regulatory oversight over earnings, the Commission aligned the financial incentives faced by the Company with the marketplace. In contrast to the disincentives provided by rate of return regulation, price regulation encourages the Company to operate efficiently, be responsive to customers, continue to modernize its network and generally prepare itself for the future.

This review proceeding provides the Commission with an opportunity to assess the overall performance of the Plan in light of the goals and objectives it established in 1994. In conducting this review, the Plan's performance must be viewed from a long-run perspective. The most significant customer benefits from price regulation are achieved over time, as the environment in which Ameritech Illinois operates becomes riskier. This review also provides an opportunity to fine-tune certain components of the Plan, in light of marketplace developments and any perceived shortcomings over its first five-year term. However, the Commission can and should adopt only those changes which will preserve and enhance the benefits of price regulation.

As the record in this proceeding demonstrates, the Plan worked well over its first five-year term. Customers of noncompetitive service received all of the price benefits and protections which the Commission anticipated in 1994, saving $943 million cumulatively through the end of 1999. The Company streamlined its operations and stimulated demand for its services, thereby increasing overall productivity and providing more value to customers. Ameritech Illinois more than met its commitment to invest $3 billion in its network. Finally, Ameritech Illinois assumed responsibility for capital recovery and revised its depreciation practices based on a more realistic assessment of the economic value of its assets, all without any increase in noncompetitive service rates.

The Commission Staff agrees that, overall, both customers and the Company have benefited under the Plan and that it should be extended in the future. Although Staff has proposed changes to address service quality -- changes to which Ameritech Illinois does not object in principle -- Staff does not believe that any other major modifications are required to the Plan and does not support any reductions in Ameritech Illinois' noncompetitive service rates.

The Governmental and Consumer Intervenors ("GCI") are the only parties to propose a major overhaul of the Plan. Their recommendations are based primarily on Ameritech Illinois' earnings over the last six years. As Staff and Ameritech Illinois agree, however, earnings are not the measure of the Plan's success or failure. Success is defined by whether prices for noncompetitive services were appropriate during the initial five-year term of the Plan, and they were. In fact, price regulation provides incentives to increase efficiency, invest in network modernization and (in Ameritech Illinois' case) assume responsibility for capital recovery precisely because the regulated company is allowed to earn well if it performs well and if economic conditions permit. It would send a chilling signal to Ameritech Illinois and all other telecommunications carriers in Illinois if the Commission were to change this regulatory compact just because the earnings outcome was different from what might have occurred under rate of return regulation. Even if the Commission does review Ameritech Illinois' earnings, they were reasonable.

Beyond that, GCI's demand for massive price reductions in excess of $1 billion, bears no relationship to economic reality. If adopted by the Commission, this pricing proposal would have a devastating effect on competition, it would financially cripple Ameritech Illinois and it would disincent future investment in infrastructure in Illinois, not only by the Company, but by all carriers. Such a result would benefit no one in the long run -- not Ameritech Illinois' customers, whom GCI purports to represent; not competitors; and not the State of Illinois.

B. MODIFICATIONS TO THE PLAN

The Plan adopted by the Commission in 1994 subjects Ameritech Illinois' noncompetitive service rates to a price index. The Company's ability to change those rates is limited by inflation in the general economy (GDPPI), offset by Ameritech Illinois' own historical productivity growth and any penalties resulting from a failure to meet specified service quality standards. The Plan contains other mechanisms designed to limit the Company's ability to increase rates within the confines of the index (i.e., the 2% limit on pricing flexibility and the residence rate cap) during the Plan's initial term.

Overall, the Plan fully met the statutory standards in Section 13-506.1(b) of the Act during its initial five-year term. Ameritech Illinois' noncompetitive service rates remained just and reasonable; the Plan responded to the changes in technology and the structure of the industry which were, in fact, occurring; customers appropriately benefited from the efficiency gains and cost savings which resulted from the Plan; the quality and availability of telecommunications service was generally maintained; no particular customer class was prejudiced or disadvantaged; and the public interest was served. In addition, although not required, the Plan also advanced the policy goals set forth in Sections 13-506.1(a) and 13-103 of the Act (e.g., reduction in regulatory delay and costs, service innovation, increased efficiency, broad dissemination of technical improvements to all classes of customers and economic development).

As a result, Ameritech Illinois is not proposing significant changes in the price index or the Plan generally. All parties agree that GDPPI is the proper measure of inflation and that the productivity offset should be based on the performance of the entire telecommunications industry, not Ameritech Illinois' alone, now that industry-wide data are available. Ameritech Illinois and Staff agree that a 3.3% productivity growth factor should be used in the index on a going forward basis and that GCI's proposal to base the offset on the CALLS proposal adopted by the Federal Communications Commission ("FCC") should be rejected. The Company is recommending, however, that the 1% consumer dividend in the productivity offset be eliminated -- a proposal with which Staff disagrees -- because it flowed through to ratepayers more productivity gains than the Company actually achieved.

The Company is also proposing that significantly greater pricing flexibility be permitted under the Plan, both by consolidating the basket structure and increasing the permitted percentage price changes for individual services. A well-designed price regulation plan allows the incumbent carrier to adjust its rates upwards and downwards within reasonable limits to adjust to the more competitive marketplace and to make gradual progress toward a more economically efficient rate structure. The opposition of Staff and GCI to increased pricing flexibility reflects a shortsighted and ultimately counter-productive view of what constitutes "harm" to ratepayers.

Regarding service quality, the Plan has generally met the statutory goal of maintaining the levels of performance which the Commission found to be fully satisfactory in 1994. With the exception of the measure for out-of-service over 24 hours ("OOS>24"), Ameritech Illinois not only met the Commission's benchmarks, but improved its performance substantially. While Ameritech Illinois recognizes that it failed to provide installation and repair service in a timely manner during the second half of 2000, those problems reflected only a short-term aberration in what has been, overall, a very strong service quality record. They do not call into question the overall success of the Plan.

As a result, the service quality component of the Plan should be changed only slightly. Ameritech Illinois has agreed with Staff's proposed changes to the service quality measures tracked by the Plan. Penalties for missed measures should continue to be handled within the price index, an approach which Staff finds acceptable. Performance benchmarks should reflect Ameritech Illinois' historical performance and penalties for missing benchmarks should be established at reasonable levels. The Commission should also add an element of symmetry to the Plan by allowing the Company to remove any service quality adjustments from the price index calculation if, after missing a benchmark in one year, it then improves service and meets that benchmark in the subsequent year.

GCI's service quality proposal should be rejected out of hand. GCI's recommendation that the number of service quality measures included in the Plan should be increased from eight to twenty is regulatory overkill. GCI's performance benchmarks vastly exceed what is necessary to deliver quality service to customers and they bear no relationship to carrier performance in the real world. GCI's penalty structures would impose billions of dollars in penalties on the Company, even if it consistently provides excellent service. In fact, even if Ameritech Illinois performed at 1999 levels, when it satisfied all of the benchmarks in the existing Plan, GCI's proposal would result in such massive rate reductions that, by the fifth year of the Plan, <u>Ameritech Illinois</u> would be paying <u>customers</u> to use its noncompetitive services. Similarly, the Commission should reject Staff's primary penalty proposal, which is nearly as unreasonable and punitive as GCI's.

GCI's proposal to add an earnings sharing component to the Plan is opposed by both Ameritech Illinois and Staff. Earnings sharing fundamentally <u>is</u> rate of return regulation, as the Commission recognized in 1994. It brings with it all of the baggage of rate of return regulation:

monitoring of earnings, control over depreciation rates, regulatory pressure to engage in prudency reviews of the Company's operations and oversight of the Company's accounting practices to ensure that it is not "hiding" its earnings. GCI's claim that earnings sharing provides a necessary "safety net" rings hollow, given the fact that price regulation has now been in place for 6 years and the price index worked well over this entire period. The time for earnings sharing had already come and gone by 1994, and there is no place for it in 2001.

Finally, GCI's proposal to "reinitialize" Ameritech Illinois' rates by reducing them by over $1 billion dollars should be rejected out of hand. GCI is asking this Commission to convert the existing price regulation plan to a completely different plan: that is, price regulation with intermittent application of rate of return regulation. Such a hybrid approach is worse than rate of return regulation alone. It would destroy the incentive structure underlying price regulation, it would backtrack on regulatory commitments made in 1994 and it would jeopardize the future of competition in this state. Furthermore, GCI has been able to claim that a $1 billion rate reduction is required only by ignoring expenses Ameritech Illinois actually incurs, attributing revenues to Ameritech Illinois that it does not earn, and unraveling the depreciation freedom which the Commission granted in 1994. These kind of adjustments are wholly inappropriate in a price regulation environment, where Ameritech Illinois -- not ratepayers -- bears the entire burden of its business decisions; and in an increasingly competitive marketplace, where other providers must compete based on real expenses and real revenues.

C. <u>Revenue Requirements Analysis</u>

In support of its rate reduction proposal, GCI purported to perform a traditional "revenue requirements" analysis. Staff also provided a "revenue requirement" analysis in the event that the Commission deems it appropriate to reinitialize rates, although Staff is opposed to doing so. For the reasons summarized above, GCI's proposal to reinitialize rates on the basis of the Company's earnings during a "test year" is fundamentally incompatible with the goals of price cap regulation. Accordingly, there is no need for the Commission to make a determination of the Company's "revenue requirements."

Moreover, the revenue requirements analyses performed by GCI and Staff are fundamentally flawed. GCI and Staff arbitrarily adjusted the Company's actual operating results by (i) "disallowing" reasonable expenses actually incurred to provide service (including depreciation, incentive compensation, external relations, and brand advertising expenses) and (ii) imputing to the Company revenues which it did not (and will not) actually receive (directory revenues). The effect of these adjustments is to overstate by hundreds of millions of dollars the Company's earnings from the provision of regulated services in Illinois.

Among these improper adjustments, GCI proposes to recalculate the Company's depreciation expense on the basis of outdated FCC-prescribed parameters, rather than on the basis of the depreciation rates the Company actually used and was permitted to use under the Plan. GCI and Staff also propose inappropriate treatment of a 1994 write-down in the value of the Company's assets. The effect of these adjustments is to abrogate the capital recovery bargain between the Commission and the Company which underlies the Plan and to provide "benefits" to ratepayers to which they are not entitled.

Staff's and GCI's proposal to impute to Ameritech Illinois' regulated accounts $126 million of revenue generated by unregulated yellow page directory operations of an unregulated affiliate, Ameritech Publishing, Inc. ("API"), should also be rejected. The Commission imputed $51 million to Ameritech Illinois' regulated accounts in 1994, because Ameritech Illinois had failed to take advantage of a 1990 bargaining opportunity to increase the charges for its services under the 1984 Directory Agreement with Reuben H. Donnelley Corporation and API. That Agreement, however, expired by its own terms on December 31, 1999. Moreover, since 1994, there have been fundamental changes in the law and FCC policies relative to the prices which can be charged for directory listings. Directory publishers, including API, now pay Ameritech Illinois market rates for listing information and billing and collection services, and Ameritech Illinois has no bargaining leverage to increase those payments. Therefore, there is no longer any basis on which API revenues can be imputed to Ameritech Illinois.

D. Rate Rebalancing and Service Costs

Ameritech Illinois' rate rebalancing proposal responds to the changes that have occurred in the marketplace since 1994 and furthers this Commission's long-standing commitment to economically sound, market-based prices for telecommunications services. Due to the legacy of regulatory policies promoting universal service -- and notwithstanding significant rate design progress which this Commission made during the 1980's -- the rates for residential network access lines are still too low and should be increased. They have essentially been frozen now for 11 years. Low network access line rates discourage efficient competitors from entering the market and competing broadly for residence customers; require heavy users of the network to support low users; and generally distort the efficient utilization of societal resources.

Under the Company's rate design proposal, residence network access line rates would be increased by $2 per month across all access areas. As demonstrated by the Company's cost of service studies, these rates do not cover LRSIC in Access Areas B and C, and they fail to provide reasonable contribution to cover the shared and common costs of the business in all Access Areas. To make the proposal revenue neutral, these increases are offset by the access charge reductions which the Commission required in Dockets 97-0601/0602, reductions in the one-time charges for ordering and installing residence telephone service, lower additional minute charges for Band B residence usage and lower pay-per-use charges for certain popular custom calling features.

Ameritech Illinois's services will continue to be affordable after these long overdue rate changes are implemented. Even with a $2 increase, the "real" price of local exchange service will be lower today than it was in 1994. Thus, the vast majority of Ameritech Illinois' customers will not be negatively affected by this rate change. For low income customers, new assistance programs have been implemented since 1994 which more than offset the proposed $2 increase. Furthermore, because nonrecurring charges significantly impact whether customers subscribe to telephone service in the first instance, the Company's proposal to reduce these charges will actually promote universal service.

Staff's and GCI's opposition to this proposal is short-sighted and based on incorrect views of the relevant service costs. The cost of service studies on which the Company relied to support its rate rebalancing proposal fully comply with this Commission's long standing service cost policies and rules. The only aspect of the cost studies which Staff criticized was the Loop Facility Analysis Model ("LFAM") used to develop local loop costs. Staff's criticisms are completely unjustified. The LFAM reflects significant improvements to the model previously used to develop loop investment costs, it models efficient network engineering practices, and it fully complies with the "forward-looking" requirements of the Commission's rules. While GCI does not challenge LFAM, it did take issue with the Company's calculation of a number of inputs to its cost studies. For the reasons fully discussed infra, GCI's criticisms are meritless.

As noted previously, Ameritech Illinois strongly opposes rate reinitialization. Therefore, the Company has not proposed and does not support any rate design changes other than those included in its rate rebalancing proposal. However, if the Commission were to order lower rates -- which it should not -- the Company recommends that the service candidates should be rank-ordered as follows: residence non-recurring charges (assuming the monthly rate increases are approved), residence Band B usage, residence pay per use calling services, carrier access charges, residential ISDN lines, residential vertical features, and residential complementary central office features. The Company especially opposes the following rate changes which have been variously proposed by GCI, or Staff, or both: any reduction in monthly residence access line rates, any reduction in non-recurring charges for access lines unless accompanied by an offsetting increase in monthly rates, any decrease in the Band A untimed usage rate, any reduction in competitive service rates, and the elimination of non-list and non-pub directory assistance charges.

The remaining sections of this Initial Brief set forth in detail the Company's proposals and respond to the major issues which have been raised by Staff and the Intervenors.

II. THE ALTERNATIVE REGULATION PLAN PERFORMED WELL OVER ITS INITIAL FIVE-YEAR TERM

The initial focus of this proceeding is to evaluate the functioning of the Alternative Regulation Plan over its initial five-year term. As demonstrated below, the Plan performed well, meeting the Commission's objectives as stated in its 1994 Order and the statutory standards set out in Section 13-506.1 of the Act. Order in Dockets 92-0448/93-0239, adopted October 11, 1994 ("1994 Order").

A. THE SCOPE OF THIS REVIEW PROCEEDING IS DEFINED BY THE COMMISSION'S 1994 ORDER AND IS NARROWER THAN AN INITIAL REVIEW PROCEEDING

The scope of this proceeding is defined by the Commission's 1994 Order. The Commission fully examined the relative merits of price regulation and rate of return regulation in Dockets 92-0448/93-0239 and established a plan which satisfied the statutory goals and objectives set out in Section 13-506.1 of the Act. From the perspective of both public policy and economics, the primary focus of a review proceeding should be to:

- Determine whether the price index is tracking inflation and industry productivity accurately, since it controls noncompetitive service price changes;
- Verify that the Plan is presenting the regulated company with the desired incentives and opportunities for rational economic behavior; and
- Consider whether the Plan is producing unintended consequences that contradict the Commission's goals and fine-tune it as appropriate. (Am. Ill. Ex. 4.0, pp. 14-15; Am. Ill. Ex. 1.1, pp. 21-22).

This focus on performance is consistent with the 10 issues which the Commission designated for review in the 1994 Order. 1994 Order at p. 95.

Since the Commission reviewed the Plan in light of all the statutory criteria in 1994, GCI insists that each and every statutory criterion must be reviewed again here in detail. (GCI Ex. 1.0, pp. 9-11; Chicago Ex. 1.0, pp. 14-15). The Company recognizes that it is important to assess these criteria to ensure that the Plan has not materially failed. However, nothing in the 1994 Order suggests that the Company must "prove up" again each and every finding that the

Commission made in 1994. The relevant question is whether the Plan generally met the Commission's expectations, as expressed in that Order.

The City of Chicago goes further and contends that Ameritech Illinois must compare every outcome under the Plan with what would have happened had the Commission continued rate of return regulation. (Chicago Ex. 1.0, pp. 15-16.). This is an impossible standard. As Dr. Harris explained, "no one can redo history". (Am. Ill. Ex. 4.2, p. 11). Not only would Ameritech Illinois have to determine how every management decision made over the last six years would have been affected by rate of return regulation, that comparison would have had to be made over all of the different economic, technological and competitive scenarios which might have occurred. Companies do not maintain "side ledgers" which chronicle decisions that would have been made under circumstances that did not exist. (Am. Ill. Ex. 1.1, pp. 100-101; Am. Ill. Ex. 1.4, pp. 48-49). Moreover, nothing in the 1994 Order even remotely suggests that this proceeding would include a general rate case. (Am. Ill. Ex. 1.1, pp. 22-23). As will be discussed in more detail infra, an earnings review is fundamentally inconsistent with price regulation.

Consistent with the 1994 Order, the focus of this proceeding should be on the key components of the Plan and any areas in which the Plan demonstrably did not meet the Commission's expectations.

B. THE PLAN MET THE COMMISSION'S GOALS SET FORTH IN THE 1994 ORDER

The Commission's overriding objective in 1994 was to create a new regulatory framework for Ameritech Illinois which would accommodate the increasingly competitive market for telecommunications services in Illinois. 1994 Order at pp. 3-4, 19-20. As demonstrated in that proceeding, rate of return regulation has serious deficiencies: it provides regulated companies inadequate incentives to operate efficiently, develop new products and services, and make increasingly risky investments in a marketplace dominated by technological change. It subjects customers to the downside risks of competition (i.e., the potential for declining revenues and stranded or underutilized investment as competitors gain share in the marketplace). It has, as its premise, a regulatory bargain between the regulator and the regulated company -- particularly with respect to capital recovery -- which cannot be fulfilled in a competitive marketplace. Finally, it is not adaptable as the marketplace becomes more competitive. (Am. Ill. Ex. 1.1, pp. 6-8; Am. Ill. Ex. 4.0, pp. 4-6; Staff Ex. 1.0, pp. 12-13).

To address those problems, the Commission replaced rate of return regulation in toto with price regulation. Although the Commission reviewed the Plan under all the statutory requirements in Section 13-506.1, there were four primary goals which provided the policy underpinnings for the Commission's decision:

- to provide price protection and benefits to customers of Ameritech Illinois' noncompetitive services;
- to create an environment in which Ameritech Illinois would be incented to invest in its network;
- to establish a regulatory structure which would encourage Ameritech Illinois to operate efficiently and prepare itself for competition; and,
- to allow Ameritech Illinois to address its capital recovery problems without increasing noncompetitive service prices. (1994 Order at pp. 19-20, 54-56, 65, 181-182, 186, 187-88).

In fact, customers of Ameritech Illinois' noncompetitive services did receive the benefits which the Commission expected to result from the Plan. First, customers of Ameritech Illinois' noncompetitive services saved $943 million on a cumulative basis through 1999 as a result of the Plan. When viewed in light of (i) the Consumer Price Index (CPI), the most widely accepted measure of price changes for consumer goods, and (ii) increases in consumer purchasing power as measured by the Bureau of Economic Analysis over the 1995-99 period, Ameritech Illinois' noncompetitive service rates are substantially more affordable today than they were in 1994 -- and, even then, they were among the lowest in the industry. (Am. Ill. Ex. 1.1, pp. 11-14). The rate reductions required by the Plan also stimulated new demand for Ameritech Illinois' products and services, which further increased the benefits to consumers. (Am. Ill. Ex. 1.4, pp. 8-11).

Second, the Plan did create an environment which incented Ameritech Illinois to invest in its network. As part of its initial proposal, Ameritech Illinois committed to invest $3 billion in its network over the first five years of the Plan. In fact, Ameritech Illinois spent $3.7 billion, which exceeded its commitment. Substantial investments have been made in deploying fiber facilities, SS7 technology and AIN capabilities in the Company's network. These technologies improve efficiency and reliability in the transport of voice and data communications and are essential building blocks in providing the advanced services of the future. The Company has also expended many millions of dollars modifying its network to open it fully to competition, including the establishment of 2-PIC capabilities for local toll calls, number portability for local exchange service, collocation facilities, unbundled network elements ("UNEs") and operating support systems ("OSS") for CLECs. These expenditures have facilitated the entry of competitors. These competitors have in turn brought advanced services of their own to the State, contributing to a "network of networks" which enhances economic development. (Am. Ill. Ex. 1.1, pp. 14-16; Am. Ill. Ex. 5.0, pp. 3-5).

Third, the Plan provided Ameritech Illinois with the expected incentives to operate efficiently and prepare itself for competition. For example, Ameritech Illinois' total factor productivity ("TFP") growth, relative to the economy as a whole, increased from 1.3% to 3.1% over the first five years of the Plan. (Am. Ill. Ex. 2.2, p. 5). Looking at common measures of productivity in the industry (i.e., employees per 100 access lines and expenses less depreciation per 100 access lines), Ameritech Illinois' performance consistently improved. (Am. Ill. Ex. 1.1, pp. 31-33). Ameritech Illinois also reorganized its operations to focus on the customers it serves by creating "business units" dedicated to the residence, business and wholesale segments of the marketplace and generally streamlined its decision-making processes. (Am. Ill. Ex. 1.1, pp. 16-18).

Finally, the Plan granted Ameritech Illinois the freedom to manage its capital recovery shortfall. At the time of the 1994 Order, major categories of the Company's plant were seriously underdepreciated.[1] Therefore, in late 1994, Ameritech Illinois wrote down its assets by $1.152 billion for financial reporting purposes and increased the depreciation rates applicable to remaining investments in these plant accounts. As a result, the Company's depreciation reserve position has improved significantly. (Am. Ill. Ex. 1.1, pp. 19-20, 102-103). This aggressive correction was implemented without any change in customer rates, as the Commission intended. The fact that the Company's earnings were not constrained following the write-down mitigated the negative financial impact that this action would otherwise have imposed on the Company and its investors. (Am. Ill. Ex. 1.3, pp. 101-02).[2]

In short, the Plan fully met the principal policy goals established by the Commission in 1994.

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1 For example, copper facilities which constitute the backbone of Ameritech Illinois' outside plant are, and have been for many years, in economic jeopardy, because they cannot provide the full array of advanced broadband services which are expected to dominate the communications marketplace of the future. Similarly, the existing configuration of digital switches will be transformed and/or replaced entirely as data traffic grows and dwarfs traditional analog voice traffic. (Am. Ill. Ex. 1.1, pp. 18-19).

2 GCI witness TerKeurst claimed that the Company had attempted to recover these costs in rates through the input assumptions in LRSIC and TELRIC studies. (GCI Ex. 11.0, pp. 14-17). She was incorrect. These cost study input assumptions have nothing to do with recouping either the write-down or increased depreciation expense from noncompetitive service rates. (Am. Ill. Ex. 1.4, pp. 13-16).

C. THE ISSUES SPECIFIED IN THE 1994 ORDER WERE ADDRESSED

As discussed previously, the Commission framed this review proceeding in its 1994 Order by requiring Ameritech Illinois to address 10 issues in particular. 1994 Order at pp. 94-95. Ameritech Illinois submitted the requested information in its direct testimony in this proceeding. Some of these issues were the subject of dispute and further analysis in this proceeding; some were primarily informational in nature. Attached as Appendix A is a general summary of the Company's response.

D. THE STATUTORY CRITERIA SET FORTH IN SECTION 13-506.1 OF THE ACT WERE MET

When approving Ameritech Illinois' Alternative Regulation Plan in 1994, the Commission had to make seven affirmative findings under Section 13-506.1(b) and "consider" six additional policy goals set out in Sections 13-506.1(a) and 13-103. With respect to these latter policy goals, the Commission concluded that, although an overall assessment as to whether the Plan "constitutes a more appropriate form of regulation" is required, it was not necessary to make an affirmative finding on each and every one. 1994 Order at p. 180. In determining that the Plan met these regulatory criteria in 1994, the Commission expressed expectations as to how they would be met. 1994 Order at pp. 179-192. In its testimony and this Initial Brief, the Company has evaluated the Plan's performance in the context of those expectations.

1. Fair, Just, and Reasonable Rates

Under Sections 13-506.1(b)(2) and 13-506.1(a)(6), any plan of alternative regulation must produce fair, just and reasonable rates for consumers. In 1994, the Commission addressed this issue in two ways: (1) because Ameritech Illinois' last general rate case had been in 1989, the Commission conducted a traditional earnings analysis to establish an appropriate starting point for noncompetitive service rates under the Plan; and (2) the Commission adopted a price index to ensure that those rates remained fair, just and reasonable over time. The Commission found that this index would continue to produce reasonable rates because it appropriately reflected the impact of economy-wide cost changes which should be flowed through to consumers, less an appropriate productivity offset. The Commission further found that, by linking price changes to cost changes in the economy (rather than to the Company's own internal costs), the Plan would "protect ratepayers from the impact of competition and management error." The Commission also noted that, given the magnitude of the productivity offset which had been selected, both the "real" and actual prices of noncompetitive services were likely to decline. 1994 Order at p. 186.

Ameritech Illinois' noncompetitive service rates performed precisely as the Commission expected. The price index included appropriate measures for both inflation (GDPPI) and the productivity offset, which flowed through to consumers all of the productivity gains achieved by the Company during the 1995-99 period. (Am. Ill. Ex. 1.1, pp. 29-30; Am. Ill. Ex. 2.1, pp. 7-9). As the Commission predicted, the real and actual prices of noncompetitive services fell significantly over the 1995-1999 period. (Am. Ill. Ex. 1.1, p. 68). The Commission Staff agrees that these rates do not need to be changed. (Staff Ex. 1.0, p. 24; Tr. 1192-93). Both Mr. Hoagg, Staff's principal policy witness, and Dr. Staranczak, Staff's lead economist, were fully satisfied with the overall price performance of Ameritech Illinois' noncompetitive services. (Tr. 1217, 1223-26, 1249-54.) Accordingly, the Commission can and should conclude that Ameritech Illinois' noncompetitive service prices are fair, just and reasonable within the meaning of Section 13-506.1 and the Plan adopted in 1994.

Although not required to satisfy the statutory standard, Ameritech Illinois also provided external benchmark comparisons to further support the reasonableness of its noncompetitive service rates. One such standard is "affordability", which is referenced in Section 13-103(a) of the Act. By comparing rate changes under the Plan to both the CPI and changes in wage levels over the 1994-99 period, the Company demonstrated that its noncompetitive rates are significantly more affordable today than they were in 1994. (Am. Ill. Ex. 1.1, pp. 13-14, 72-73). Ameritech Illinois' rates are also lower than those of other telephone companies, both in Illinois and nationwide, and are comparable to those of its Illinois competitors. (Am. Ill. Ex. 1.1, pp. 73-75, Schs. 5 and 6).

Thus, the GCI parties are alone in claiming that the Company's noncompetitive rates are unjust and unreasonable under the statute. However, they have advanced no legal or policy interpretation of "just and reasonable" that has policy or legal meaning in the context of price regulation. Rather, they have simply recycled the traditional earnings analysis used in rate of return regulation -- precisely the regulatory model which the Commission rejected in 1994 and which price regulation replaced in its entirety. Their approach is conceptually invalid and should be rejected by the Commission.

First, the meaning of the statutory terms "fair, just, and reasonable" under Section 13-506.1(a) and (b) must reflect the overall purpose of this Section and the Commission's 1994 Order. Section 13-506.1 of the Act clearly contemplates that the Commission may substitute alternative forms of regulation for rate of return regulation in toto:

> "Section 13-506.1(a). Notwithstanding any of the ratemaking provisions of the Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services including, but not limited to, price regulation, earnings sharing, rate moratoria, or a network modernization plan." (Emphasis added).

Thus, based on a plain reading of the statute, the meaning of "just and reasonable" rates must be based on something other than traditional rate of return principles. Otherwise, the statute is circular: that is, the Commission could approve alternative forms of regulation, but only if they produce precisely the same rates as a traditional rate case. This is nonsensical and violates accepted canons of statutory construction. Collinsville Comm. Unit School Dist. No. v. Witte, 5 Ill. App. 3d 600, 283 N.E. 2d 718, 720 (5th Dist. 1972).

Second, earnings analysis flies in the face of the economic and public policy objectives underlying price regulation. The incentive mechanisms which lie at the heart of price regulation -- and which deliver benefits to consumers in the form of improved efficiency, investment in the network, and innovation in services -- are based on the fact that there is no ceiling on earnings. (Am. Ill. Ex. 1.1, pp. 95-96; Am. Ill. Ex. 4.0, pp. 7-8, 15-16). By subjecting itself to price regulation, Ameritech Illinois assumed the risk of earning less than a "reasonable" return on equity and rate base, in exchange for the opportunity to earn in excess of what would typically be permitted in a rate of return environment. This was fully understood in 1994. 1994 Order at pp. 7-12, 181-82. As Dr. Staranczak testified:

> "Under alternative regulation subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech Illinois gets the opportunity to earn higher returns. If Ameritech does indeed earn higher returns under alternative regulation this should not be interpreted as a failure of the Plan but recognized as one of the possible outcomes that was anticipated." (Staff Ex. 2.0, pp. 4-5).

Indeed, there would have been no equitable or policy justification for the Commission to impose on Ameritech Illinois -- or for Ameritech Illinois to accept -- the downside risks of a price regulation plan in 1994 if the upside potential would last only until this review proceeding. (Am. Ill. Ex. 1.1, pp. 97-99). In response to persistent questioning by GCI attorneys, Dr.

Staranczak testified unequivocally that earnings are irrelevant in determining whether the Plan functioned properly. (Tr. 1249-54, 1266-67, 1281-82, 1284).

In fact, price regulation coupled with intermittent earnings reviews is worse -- financially and administratively -- than continuation of rate of return regulation. Under this approach, the Company is required to reduce rates annually according to the price index -- something which no rate of return company must do -- and be subject to a general rate proceeding after five years. A five-year interval is no longer and, in many instances, shorter than what the Commission has applied to Illinois rate of return companies. In addition, Ameritech Illinois would have to bear the administrative and regulatory costs associated with both the annual price index filings and a general rate case. This would be more burdensome, not less burdensome, than rate of return regulation, where the annual filing costs do not exist. (Am. Ill. Ex. 1.1, pp. 68-70, 100).

GCI further contends that this earnings analysis must be performed for Ameritech Illinois' total intrastate operations.. (GCI Ex. 1.0, pp. 13-16; Chicago Ex. 1.0, pp. 43-46). GCI is incorrect as a matter of law. Both Section 13-506.1(a) and the Commission's 1994 Order clearly limit the Plan to noncompetitive services. Contrary to Ms. TerKeurst's assertions, neither Section 13-506.1(a), which authorizes the Commission to adopt earnings sharing; nor the "public interest" standard in Section 13-506.1(b)(1) extend the application of the statute to competitive services. (Am. Ill. Ex. 1.3, pp. 24-27). Similarly, the Commission's 1994 Order expressly excluded competitive services from the operation of the Plan:

> "Price regulation directly ensures that noncompetitive rates will remain just and reasonable, while market forces will control competitive service prices and earnings." 1994 Order at p. 187.

The Company recognizes that substantial disputes exist between GCI and Ameritech Illinois relative to competitive service rates, competitive service reclassifications and the pricing actions which the Company has taken over the last five years relative to those services. (Am. Ill. Ex. 1.3, pp. 29-30). However, competitive service prices are not within the scope of this proceeding, which was initiated to assess the functioning of the Plan. The functioning of the Plan cannot reasonably be indicted based on service rates and earnings which were not subject to it in the first place. (Am. Ill. Ex. 1.3, pp. 27-28). The outstanding issues associated with service reclassifications should be and will be resolved in other proceedings, such as Docket 98-0860 (competitive classification of certain business services).(Am. Ill. Ex. 1.3, pp. 30-31; Staff Ex. 2.0, p. 5).[3]

Ms. TerKeurst further attempted to justify GCI's position on the grounds that high earnings can raise a "warning flag" that the terms of the Plan may have been too favorable to the utility. (GCI Ex. 1.0, pp. 11-12). However, "warning flags" do not translate into rate cases unless the record demonstrates that the price index seriously malfunctioned. That is not the case here. The price index was set properly, Ameritech Illinois implemented the required rate changes and there is no evidence whatsoever that the resulting noncompetitive service rates are unreasonable.

Thus, even if the Commission were to use an earnings analysis to evaluate whether Ameritech Illinois' rates are just and reasonable -- which it should not --the analysis would have to be limited to noncompetitive services. Ameritech Illinois demonstrated that its 1999 earnings on noncompetitive services were only 5.55%, well below Ameritech Illinois' weighted cost of capital under either Staff's analysis or the Company's. (Am. Ill. Ex. 1.1, pp. 76-80; Am. Ill. Ex. 1.6, p. 2; Am. Ill. Ex. 6.0, p. 40; Staff Ex. 11.0, p. 32). No party disputed the mechanics of this

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[3] Ameritech Illinois further notes that the Commission's ratemaking policies for competitive services have never been carrier-specific and have never been based on earnings analyses; for example, the Commission imposed rate caps on operator services calls by rule for the entire industry, solely based on AT&T's then existing rates. (Am. Ill. Ex. 1.4, p. 41).

allocation methodology or demonstrated that the results were in any way unreasonable. Supporting this view, Mr. Hoagg testified in cross-examination that he would only be concerned if Ameritech Illinois' noncompetitive services were generating extremely high earnings, over an extended period of time, and, even then, only if further investigation revealed that these earnings were inconsistent with the policy underpinnings of price regulation. (Tr. 1223-26). None of these factors apply here.

Dr. Selwyn and Staff witness Marshall rejected the Company's noncompetitive service earnings analysis, claiming that jointly used plant and common costs cannot be meaningfully allocated between competitive and noncompetitive services. (Chicago Ex. 2.0, pp. 20-21; Staff Ex. 4.0, p. 6; Staff Ex. 18.0, pp. 7-8). They are incorrect. Jointly used plant and common costs have been separated between the state and interstate jurisdictions for ratemaking purposes for decades through the separations process. (Am. Ill. Ex. 1.4, pp. 37-41). Regulated costs are routinely separated from unregulated costs to comply with the FCC's Part 64 requirements and Part 711 of this Commission's rules. Common costs are routinely allocated between competitive and noncompetitive services under the Aggregate Revenue Test to comply with Section 13-507 of the Act for ratemaking purposes. Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 3d 424, 561 N.E.2d 426 (2nd Dist. 1990); Order in Docket 89-0033 (Remand), adopted November 4, 1991, at pp. 200-203. In fact, professional economists testifying in the 1994 proceeding, including Dr. Selwyn himself, proposed allocation methodologies to separate competitive and noncompetitive service earnings. (Am Ill. Ex. 1.3, pp. 24-25). The Company's analysis is based on essentially the same approach as the Aggregate Revenue Test and provides a valid basis for determining noncompetitive service earnings. (Am. Ill. Ex. 1.1, pp. 78-79; Am. Ill. Ex. 1.4, pp. 37-41).

In short, Ameritech Illinois' noncompetitive service rates are "fair, just and reasonable" within the meaning of Section 13-506.1 under whatever standard the Commission may wish to apply.

2. Changes In Technology And The Structure Of The Telecommunications Industry

Under Section 13-506.1.(b)(3) of the Act, an alternative form of regulation must respond to the changes in technology and the structure of the telecommunications industry that are, in fact, occurring. In its 1994 Order, the Commission found that that the Plan met this objective because Ameritech Illinois' market environment would be increasingly competitive; that significant changes in technology were taking place; and that price regulation was better suited to these changes than rate of return regulation. 1994 Order at pp. 187-88.

The market environment has clearly become more competitive. There are many more, and many more diverse, providers today than there were in 1994; and these competitors are successfully winning business from Ameritech Illinois. For example, in 1994, CLECs like MFS and TCG were just beginning to offer switched services to customers in Ameritech Illinois' service territory. Today, the Commission has certificated at least 59 CLECs, which collectively use a mix of resold services, UNEs and their own facilities to provide local exchange service. These CLECs include major IXCs like AT&T and MCI, fixed wireless competitors, cable companies and data CLECs. (Am. Ill. Ex. 4.0, pp. 19-20, 37-40). The scope of local competition has increased to the point where CLECs now have investments in place that can readily serve most of Ameritech Illinois' business and residential customers. (Am. Ill. Ex. 4.0, pp. 17, 40-43).

There have also been significant changes in technology. An explosion in data traffic, driven in significant part by the Internet, is transforming the industry and requiring significant changes in Ameritech Illinois' network and network architecture. For example, in 1994, the Internet was just beginning to be used for commercial applications and voice communications constituted 87% of the revenue generated by the network. Today, business customers are restructuring their operations around the Internet and 45% of U.S. households have Internet access. (Am. Ill. Ex. 4.0, pp. 19, 28-29). Traffic on the network has fundamentally shifted from voice to data, and Internet transactions are substituting for voice transactions. (Am. Ill. Ex. 4.0, pp. 23, 29-30). Wireless capacity has expanded rapidly and prices have declined, as customers increasingly substitute wireless for wireline calls. (Am. Ill. Ex. 4.0, pp. 30-33).

Thus, the marketplace dynamics which drove the adoption of price regulation in 1994 are even more compelling today. (Am. Ill. Ex. 1.1, pp. 8-10; Am. Ill. Ex. 4.0, pp. 17-45). Ameritech Illinois will be subject to increased pressure from competitors using different, and more advanced, technologies than exist today in the Company's network and to which the Company will have to respond to remain competitive. (Am. Ill. Ex. 4.0, pp. 43-45). Dr. Harris testified as follows:

> "The point is that the competitive risks which the Commission identified in 1994 have escalated dramatically. We are well beyond the point where regulators can try to use the regulatory process to manage these changes or handicap the incumbent carrier at the risk of the customers whose interests they safeguard. The alternative regulation plan under which the Company has operated since 1994 is the appropriate means for placing competitive risks and opportunities fully on Ameritech Illinois while giving ratepayers whatever residual protection they need." (Am. Ill. Ex. 4.0, p. 45).

3. Efficiency Gains and Cost Savings

Sections 13-506.1(b)(5) and 13-506.1(a)(3) require findings that the Plan will promote efficiency and that ratepayers will benefit from any efficiency gains, cost savings and productivity improvements arising out of the regulatory change. In 1994, the Commission concluded that the Plan would provide Ameritech Illinois with incentives to implement cost saving efficiencies and new services, because of the potential for higher earnings if the Company were successful. The Commission further determined that ratepayers would benefit from these efficiencies and new services through the X factor, which would apply regardless whether the expected productivity gains were achieved. 1994 Order at pp. 188-89.

In fact, the Plan did provide Ameritech Illinois with new incentives to become more efficient. As described previously in Section II.B., Ameritech Illinois not only maintained, but increased, its productivity over the term of the Plan, and improved its performance on standard measures of efficiency in the industry. As will be discussed in more detail infra, the X factor was higher than Ameritech Illinois' total productivity gains; therefore, consumers reaped all of the gains which Ameritech Illinois achieved, as well as some that it did not, which more than satisfies the statutory standard. (Am. Ill. Ex. 1.1, pp. 83-84).

Contrary to Ms. TerKeurst's suggestion, Ameritech Illinois' efficiency gains were not achieved at the expense of service quality. (GCI Ex. 11.0, pp. 13-14). As will be discussed in more detail in the next section, service quality was generally excellent during the 1994-99 period.

4. Service Quality

Under Section 13-506.1(b)(6), the Commission must find that an alternative plan of regulation will "maintain" the quality and availability of telecommunications services offered by the applicant carrier. The Commission must also consider whether the plan will disrupt the telecommunications system or consumer services under Section 13-103(c). In its 1994 Order, the Commission found that the then current quality of service provided by Ameritech Illinois was "fully satisfactory". The Commission concluded that the service quality component of the price index, which included penalties, would provide Ameritech Illinois with incentives to maintain service quality. The Commission also concluded that the incentives to invest in its network and the pricing restrictions in the Plan would ensure the availability of services to consumers. Finally, the Commission concluded that nothing in the Plan would change the way Ameritech Illinois delivered service to its customers. 1994 Order at pp. 184, 189-90.

Ameritech Illinois' overall quality of service during the first five-year term of the Plan was excellent. (Am. Ill. Ex. 1.1, pp. 37-39, 84-85). In fact, on the whole, service quality has improved significantly under the Plan—the principal exception being the measure for out of service over 24 hours ("OOS>24"). For example, during the initial term of the Plan, Ameritech Illinois' performance improved for seven of the eight current benchmarks—in many cases very significantly. (Am. Ill. Ex. 12.0, pp. 14-22; Am. Ill. Ex. 12.1, pp. 6-8). Even if one judges service quality on the bases suggested by Staff's or GCI's witnesses, performance has clearly improved. Furthermore, nothing in the Plan reduced, restricted or diminished the availability of Ameritech Illinois' services or disrupted the system or consumers. (Am. Ill. Ex. 1.1, pp. 92-93).

Mr. McClerren focused on so-called monthly "misses" in his direct testimony. (Staff Ex. 8.0, p. 6). However, aside from OOS>24, monthly data confirm that Ameritech Illinois' performance has improved steadily under the Plan. For the other seven measures, Ameritech Illinois' performance exceeded the benchmarks for 399 of 420 monthly data points (95%). Moreover, the number of monthly "misses" fell steadily between 1994 (17 misses) and 1999 (four misses). Considering that those benchmarks were based on annual, not monthly, performance during 1990-91, that is a remarkable record. (Am. Ill. Ex. 12.1, pp. 15-17). In his rebuttal testimony, Mr. McClerren suggested comparing the average level of performance prior to the adoption of the Plan (using data for the periods 1990-94 and 1990-91) to performance since the Plan was adopted (1995-2000). Those comparisons confirm that performance has improved substantially, again with the single exception of OOS>24. (Am. Ill. Ex. 12.2, pp. 6-8).

Ms. TerKeurst argued that performance for measures that are not included in the Plan must also be considered. (GCI Ex. 12.0, pp. 3-6). However, that analysis (which Ms. TerKeurst failed to perform herself) further supports a positive finding on service quality. To the extent relevant pre-Plan data are available, they show that Ameritech Illinois' performance has generally improved, not declined, since the Plan was adopted. (Am. Ill. Ex. 3.4, pp. 17-19 & Sch. 3.44).

5. Prejudice Or Disadvantage To Customers

Under Section 13-506.1(b)(7), an alternative plan of regulation must not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers. In addition, the Commission must consider whether the Plan would result in discrimination or cross-subsidies under Section 13-103(d). In its 1994 Order, the

Commission concluded at that time that the basket structure would ensure that all customer classes would be treated equitably. The Commission also concluded that the pricing flexibility limitations and residential price cap would protect residential customers; and that carriers were further protected by the requirement that intrastate carrier access rates could not exceed interstate carrier access rates. 1994 Order at pp. 190-91. With respect to discrimination and cross-subsidies, the Commission relied on the reasonableness of the Company's going-in rates, as well as the Imputation and Aggregate Revenue Tests. 1994 Order at p. 185.

The basket structure and residential rate protections functioned precisely as the Commission intended. All rate reductions required by the Plan were flowed through equitably to each customer group. The limits on pricing flexibility, combined with the low rate of inflation over this period and the residence rate cap, more than protected consumers of noncompetitive services from any rate increases; in fact, those rates declined. There were no rate-related complaints of any significance over the Plan's initial term. Finally, all of the statutory service cost and pricing rules continued in effect and the Company has complied with them. (Am. Ill. Ex. 1.1, pp. 85-86, 93).

Clearly grasping at straws, Dr. Selwyn claimed that the Plan disadvantaged noncompetitive service customers because the productivity offset "was woefully insufficient and misspecified". (Chicago Ex. 1.0, pp. 50-51). This is nonsense. The offset in the Plan today was based on Ameritech Illinois' own productivity performance and Dr. Meitzen's updated Company-specific analysis for the 1992-99 period demonstrates that it was, if anything, too high. (Am. Ill. Ex. 1.1, pp. 29-30). This analysis was not contested by any party to the proceeding.

6. Regulatory Delay and Costs

Section 13-506.1(a)(1) requires the Commission to consider whether alternative regulation will reduce regulatory delay and costs. In its 1994 Order, the Commission recognized that traditional rate of return regulation imposed significant costs on all parties involved, with exhaustive 11-month proceedings. The Commission found that price regulation, in contrast, would permit streamlined proceedings and would eliminate regulatory review of the "prudence of incurred costs, equipment replacement and cost of capital". 1994 Order at pp. 180-81. The Plan clearly met these expectations. The annual filing process has worked well: it has been very streamlined and rate changes go into effect in three months, not 11 months. (Am. Ill. Ex. 1.1, pp. 87-88).

Again grasping at straws, Dr. Selwyn has suggested that the cumulative time and effort required by Dockets 92-0448/93-0239 and the annual price cap filings exceeded the resources that would have been consumed by rate of return regulation. (Chicago Ex. 1.0, pp. 31-33). This too is nonsense. It makes no sense to count against the Plan the 22 months which it took the Commission to adopt it in the first place; this was a major regulatory change that required serious review. Moreover, it is inconceivable that any of the usual active participants in telecommunications dockets (whether the Company, Staff or intervenors) could possibly have devoted more resources to the price cap filings than they would have to one or more general rate cases during this period. (Am. Ill. Ex. 1.3, pp. 42-44).[4]

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4 Unfortunately, however, the costs associated with this review proceeding -- which has involved litigation over issues which were supposed to have been eliminated under the Plan -- are fast offsetting the regulatory savings achieved to date. (Am. Ill. Ex. 1.3, p. 45).

7. Innovation

Under Section 13-506.1(a)(2), the Commission must consider whether an alternative regulation plan will encourage innovation in services. In 1994, the Commission expected that the prospects of higher earnings would incent the Company to aggressively develop and offer new services; that the removal of prudency reviews would encourage the Company to be more innovative and take more risks; and that the ability to change prices without regulatory involvement would allow the Company to experiment more in the marketplace. 1994 Order at p. 181.

Ameritech Illinois has been more innovative. New services have been an important factor in generating revenue growth for the Company. (Am. Ill. Ex. 1.0, pp. 17-18; Am. Ill. Ex. 1.1, pp. 50-52). For example, "Privacy Manager" is a highly innovative offering, which allows customers to pre-screen their calls and eliminate telemarketing or other unwanted intrusions. Ameritech was the first RBOC in the nation to offer this service and it has been widely imitated. (Am. Ill. Ex. 1.1, pp. 31-32). The Company also experimented in the marketplace through a large number of promotional offerings and introduced optional calling plans. Today, a substantial portion of the Company's residential customers take service under one of these plans. (Am. Ill. Ex. 1.1, pp. 51-52; Am. Ill. Ex. 1.3, p. 46).

Dr. Selwyn claimed that Ameritech Illinois had not been innovative, but advanced little in support of his position. (Chicago Ex. 1.0, pp. 33-36). Although he apparently believes that the Company's usage rate structure should be less distance-sensitive, this is a rate design judgment call, not a matter of "innovation". (Am. Ill. Ex. 1.3, pp. 46-47). Dr. Selwyn also claimed that Ameritech Illinois's roll-out of DSL has been too slow. However, this service is offered by Ameritech Illinois' affiliate AADS. In other contexts, GCI has been quick to argue that AADS is not Ameritech Illinois and that AADS' investments should not be counted towards Ameritech Illinois' regulatory obligations. Therefore, AADS' deployment record cannot logically be charged against Ameritech Illinois. (Am. Ill. Ex. 1.3, pp. 47-48).[5]

8. Broad Dissemination of Technical Improvements and Economic Development

Sections 13-506.1(a)(4), 13-506.1(a)(5) and 13-103(f) require the Commission to consider whether alternative regulation plans will facilitate the broad dissemination of technical improvements to all classes of ratepayers and enhance the economic development of the State. In its 1994 Order, the Commission concluded that price regulation provided the appropriate incentives to encourage market-based investment in infrastructure; that the Company had made a $3 billion commitment to grow and modernize its network; and that, because most of Ameritech Illinois' plant-in-service is used to provide service jointly to all customer classes, all classes of customers would benefit from this investment. 1994 Order at pp. 182, 183. The Commission also concluded, based on economic analyses presented in that proceeding, that there was a generally positive relationship between network modernization and economic development:

> "The record establishes that investment in telecommunications infrastructure improves the quality and number of services, reduces the cost of those services and, therefore, contributes to overall economic development." 1994 Order at p. 183.

As noted previously, Ameritech Illinois not only met, but exceeded, its $3 billion commitment by spending $3.7 billion. Those investments facilitated the development of an advanced telecommunications infrastructure. Today, all of Ameritech Illinois' customers have digital switching capabilities available to them. Virtually all of the Company's interoffice

[5] Ameritech Illinois is no longer proposing that AADS' investment count towards its $3 billion commitment. (Am. Ill. Ex. 3.1, p. 21).

facilities are now fiber. Over 90% of the Company's access lines have access to ISDN. SS7 deployment is complete and 65% of the Company's central offices have been equipped with the AIN platform. All of these technologies are important building blocks for advanced services. As indicated earlier, Ameritech Illinois also spent millions of dollars opening its networks to competitors. Customers benefit from the expanded choice of alternative service providers. (Am. Ill. Ex. 1.1, p. 54). The positive relationship between price regulation and network modernization which the Commission relied on in 1994 has now been further validated by a NARUC/NRRI study based on empirical data from jurisdictions throughout the United States. (Am. Ill. Ex. 4.2, pp. 3-4). Accordingly, the Commission can conclude that the Plan has enhanced economic development in the State.

Ms. TerKeurst contended that Ameritech Illinois' service quality problems demonstrated that it invested in high margin services/customers at the expense of basic service customers. (GCI Ex. 11.0, p. 13). However, she advanced not a shred of evidence to support her claim. In fact, because the Company's network primarily consists of common plant, it is virtually impossible to do as Ms. TerKeurst suggests. Moreover, if any customer group benefited disproportionately from Ameritech Illinois' network investments, it is the CLECs -- who are most definitely <u>not</u> the Company's "high margin services/customers". (Am. Ill. Ex. 1.4, pp. 11-12).

9. <u>Competition</u>

Under Section 13-103(b), the Commission must consider whether any alternative regulation plan will promote the legislative goal of allowing competition to substitute for certain aspects of regulation, where consistent with the protection of consumers. In its 1994 Order, the Commission concluded that the Plan would further this goal, because price regulation better reflects the operating freedoms and constraints faced by competitive companies and reduces the economic burden of regulation generally. 1994 Order at p. 184. As previously discussed, the Plan has met the Commission's expectations with respect to these goals.

Dr. Selwyn contended that the Plan failed because it did not actually further local competition, as measured by competitive entry and competitors' market shares. (Chicago Ex. 1.0, pp. 11-12, 16-17, 30-31, 46-48). This position has no basis in the statute, economic theory or regulatory policy. By its terms, Section 13-103(b) primarily addresses the elimination of unnecessary regulatory oversight and constraints, not promoting competition per se. Price regulation is fundamentally a retail plan: it governs the pricing of Ameritech Illinois' noncompetitive services to consumers and it establishes the governance structure relative to retail service quality, network investment and financial performance. It is not a wholesale plan. Thus, price regulation plans do not themselves either encourage or discourage the development of competition, except to the extent they result in more efficient price signals to potential competitors. In fact, the original pioneering work on the merits of price regulation assumed a monopoly environment. (Am. Ill. Ex. 4.2, pp. 18-19). Since then, however, economists and regulators have concluded that price regulation is also much better adapted than rate of return regulation to the transition from monopolies to competition. No party to this proceeding has seriously disputed that fact. It makes no more sense to expect price regulation to promote competition than rate of return regulation: there is no causal relationship between either mode of regulation and "competition", as GCI uses that term. (Am. Ill. Ex. 1.3, pp. 35-36; Am. Ill. Ex. 4.2, p. 18-19). In any event, as discussed previously, it is uncontroverted that there is more competition today than there was in 1994.

Dr. Selwyn further claimed that the Plan had actually harmed competition by allowing Ameritech Illinois to shift "costs out of its 'competitive' services and onto noncompetitive services -- including such bottleneck items as switched access and unbundled network elements...". (Chicago Ex. 1.0, pp. 30-31). Nothing of the kind happened. No party has produced a shred of evidence that costs have been misallocated. Switched access rates declined more rapidly than any of Ameritech Illinois' other rates over the term of the Plan and were recently slashed by another $33 million as a result of Dockets 97-0601/0602. UNE rates were set at a very low level in 1997 based on TELRIC studies and they have not increased since then. The Plan did not have and could not possibly have had a negative impact on any of these services. (Am. Ill. Ex. 1.3, pp. 38-39).

Ms. TerKeurst claimed that the Plan impeded competition, because Ameritech Illinois had reclassified services as competitive and raised their prices. (GCI Ex. 1.0, pp. 25-30). This argument posits the relationship between price changes and competition precisely backwards. Competitors are attracted to market segments and services where there is a reasonable opportunity to make a profit. Price increases provide competitors with more, not less, incentive to enter. (Am. Ill. Ex. 1.3, pp. 39-40).

10. The Public Interest

Section 13-506.1(b)(1) requires that any alternative regulation plan serve the public interest and subsection (b)(4) requires that it be a more appropriate form of regulation, based on the Commission's overall consideration of the policy goals set forth in Sections 13-103 and 13-506.1(a). The Commission concluded in 1994 that these standards were cumulative of Section 13-506.1's other requirements and policy goals and could be resolved affirmatively if its conclusions on the other statutory requirements were positive. 1994 Order at pp. 188, 191. As discussed above, the record evidence clearly demonstrates the Plan did satisfy all of the specific statutory standards and goals; and, therefore, the Commission can conclude that Sections 13-506.1(b)(1) and (4) were also met.[6]

III. ONLY MODEST ADJUSTMENTS TO THE PLAN ARE REQUIRED ON A GOING FORWARD BASIS

As demonstrated in the previous section, the Plan met the Commission's expectations in all material respects. Only modest adjustments are required to make the Plan more adaptive for the future.

A. EXISTING COMPONENTS OF THE PLAN

1. The Price Index

The price index in the Plan has the following four components:

- the inflation factor -- inflation is represented by GDPPI, which is the economy-wide measure of inflation for all goods and services;
- the X factor -- the X factor represents the extent to which Ameritech Illinois (or the telecommunications industry in general) experience productivity growth which exceeds that of the overall economy (economy-wide productivity gains are already reflected in GDPPI) and any "consumer dividend" which the Commission may include;
- the Z factor --the Z factor captures "exogenous changes", i.e., externally driven cost or revenue changes which impact Ameritech Illinois uniquely or disproportionately relative to the overall economy; and
- the service quality factor -- the service quality factor establishes benchmarks for service and imposes penalties if service quality declines. (Am. Ill. Ex. 1.1, pp. 25-27).[7]

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[6] There is no disagreement among the parties that the Plan satisfied Section 13-103(e), which deals with legislative review of the Act.

[7] The service quality factor is addressed separately in Section IV of this Initial Brief.

a. The Measure of Inflation

In its 1994 Order, the Commission adopted GDPPI as the measure of inflation in the price index. There is no dispute among the parties to this review proceeding that GDPPI should continue to be used as the measure of inflation or that, on a going-forward basis, the chain-weighted version of GDPPI should be substituted for the fixed weight version used today. Since the Commission issued its Order in 1994, the Bureau of Economic Analysis of the U.S. Department of Commerce has adopted the chain-weighted GDPPI as the official government measure of inflation. (Am. Ill. Ex. 2.0, pp. 6-7; Am. Ill. Ex. 3.0, pp. 6-7; GCI Ex. 3.0, pp. 12-14).

b. The Productivity Offset

In its 1994 Order, the Commission adopted a 3.3% productivity offset for Ameritech Illinois, which was based on the Company's own historical TFP and input price performance over the 1984-1991 period. The Commission then added a 1.0% "consumer dividend". At that time, data was not available for the telecommunications industry as a whole. Since 1994, however, industry-wide TFP data has become available and the parties agree that the X factor should be based on industry performance, not Ameritech Illinois'. (Am. Ill. Ex. 1.1, p. 34; Am. Ill. Ex. 3.0, pp. 8-9; Am. Ill. Ex. 4.0, pp. 47-49; GCI Ex. 3.0, pp. 15-16). Thus, the only issues in dispute are the value for the X factor and whether the consumer dividend should continue.

Ameritech Illinois and Staff agree that the productivity factor should be 3.3% on a going-forward basis. (Am. Ill. Ex. 3.0, pp. 8-9; Staff Ex. 2.0, pp. 9-11; Staff Ex. 16.0, pp. 18-19). The 3.3% offset is based on an extensive study of TFP growth for the local exchange carrier industry between 1992 and 1998. (Am. Ill. Ex. 2.1, pp. 6-7). Although Dr. Staranczak initially expressed minor concerns about certain assumptions used in the study, he ultimately concluded that they were not material. (Staff Ex. 16.0, pp. 18-19).

Dr. Selwyn contended that these study results should not be used, largely because a so-called deflated revenues approach was used to quantify output, rather than a direct physical measure. (GCI Ex. 3.0, pp. 19-20). Dr. Selwyn is incorrect. As both Dr. Meitzen and Dr. Staranczak testified, the deflated revenue approach is a well-known and widely accepted method for measuring output. Furthermore, this approach was used successfully in the original Ameritech Illinois TFP study relied on by the Commission in its 1994 Order. (Am. Ill. Ex. 2.2, p. 9; Staff Ex. 16.0, pp. 8-10).

Dr. Selwyn took the position that this Commission should instead use the 6.5% offset in the CALLS proposal adopted by the FCC. (GCI Ex. 3.0, pp. 22-25). Ameritech Illinois and Staff both agree that this FCC factor is <u>not</u> a valid productivity measure and it should not be used in Ameritech Illinois' price index. (Am. Ill. Ex. 2.2, pp. 15-20; Staff Ex. 16.0, pp. 10-16). <u>First,</u> it is a "transitional mechanism" which is designed to reduce interstate rates to specified target levels and will disappear after 5 years. The FCC made very clear that it is not a measure of productivity:

> "The X-factor would serve a different function under the CALLS Proposal than in the original price cap plan. Instead of representing an estimate of expected annual productivity gains, the X-factor under the CALLS Proposal would be used to reduce local switching and switched transport rates to specified target rate levels and to reduce special access rates over a set period of time. <u>The proposal thus transforms the X-factor from a productivity factor into a transitional mechanism that operates to reduce rates at a certain pace, and it would not be linked to a specific measure of productivity.</u>" (Am. Ill. Ex. 2.2, p. 19; emphasis added).

<u>Second,</u> Ameritech Illinois and Staff further agree that FCC attempts to develop an industry productivity offset prior to the CALLS proposal (and on which Dr. Selwyn relied) were highly flawed and cannot be used in this proceeding. These shortcomings include:

- stale data -- the FCC's model only used TFP information through 1995, the first year of Ameritech Illinois' Plan;

- a single physical measure of local output (i.e., local calls or local minutes) -- local service is made up of a variety of outputs, such as access lines, usage and vertical services, and an accurate measure of local service growth must reflect weighted growth in all of these outputs;

- an output specification that does not match the sources of revenue -- for an X factor to place an appropriate ceiling on prices, it should reflect the sources of revenue growth (i.e., it should use a deflated revenue approach);

- a "residual earnings" method to estimate capital costs -- even the FCC subsequently recognized that this method was improper; and

- inappropriate measures for outputs of services other than local service and numerous accounting errors. (Am. Ill. Ex. 2.2, pp. 10-13, 15-17; Staff Ex. 16.0, pp. 10-16).

In short, the record evidence provides no support for Dr. Selwyn's proposal.

Contrary to Staff's and GCI's recommendations, the Commission should not extend the so-called 1.0% "consumer dividend" for another term of the Plan. The consumer dividend was adopted in 1994 to ensure that customers received 100% of the benefits of the Company's first productivity gains under the Plan. 1994 Order at p. 39. Unfortunately, it had the effect of flowing through all of the productivity gains that Ameritech Illinois achieved over the initial five-year period and an additional 0.8 percentage points that the Company did not achieve. (Am. Ill. Ex. 1.1, pp. 29-30). Whatever policy arguments might have supported a consumer dividend in 1994 -- when the Plan was new and the Commission had had no prior experience constructing a price index -- there is no such basis today. (Am. Ill. Ex. 3.0, pp. 9-10).[8]

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[8] Dr. Staranczak argued that a continued consumer dividend was appropriate based on a comparison of total company price changes (for both competitive and noncompetitive services) with overall inflation in the economy. (Staff Ex. 2.0, pp. 17-18). This analysis is inappropriate because the index only applies to noncompetitive services and it is undisputed the X factor required reductions in noncompetitive service rates which exceeded the productivity gains achieved by the Company. (Am. Ill. Ex. 1.3, p. 83).